HISTORY OF BANK INDONESIA : MONETARY
Period from 1983-1997

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1. Highlights

In the early period of 1982-1983, the Indonesian economy faced a heavy pressure, particularly resulted from the drop of oil price in the world market and unabated world economic recession. These affected the domestic economic activities. The competitiveness of Indonesian products weakened because of the over-valued rupiah due to high inflation rate compared to that of competitor countries or fellow main trading partners of Indonesia. Consequently, the economic growth dropped further and the balance of payment's deficit rose. To improve its economic structure, the government adopted a number of monetary control policies directed to the market mechanism. This policy began with rupiah exchange devaluation on March 30 of 1983 from Rp 702.5- to Rp 970 against USD to improve the country's competitiveness. Furthermore, the government introduced a series of deregulation measures in the financial and monetary sector through the Package of Policies of June 1, 1983 aimed to encourage the independence of the banking sector.

In 1984 the Indonesian economy grew quite significantly compared to that of previous years, but the inflation rate was creeping up as result of the rupiah devaluation and higher cost of fuel in early 1984. A few banks then relied on the inter-bank money market (PUAB) fund. BI therefore intended to reduce the banks' dependence on PUAB by setting the ceiling of PUAB fund the banks could obtain, and instead provided Special Credit Facility (FKK) with one year term. In 1986, the government again introduced rupiah devalution as the oil price went down and further lifted the swap ceiling to spur capital and fund inflow. In the following year, speculative transaction on foreign currencies was so rampant that it undermined the monetary stability. In June 1987, the government launched the tight money policy known as Sumarlin's First Move. (Sumarlin was then the Finance Minister).

Later on, during the fifth Five-Year Development Plan, the Indonesian economy was enjoying a higher growth, namely at 5.7% in 1988. This was higher than the average 5% growth. To sustain such development growth, the government again introduced Deregulation Policy Package for the Monetary, Finance and Banking on 27 October 1988 (Pakto 1988). This was a further development of the March 1989 Package and January 1990 Package aimed to curb inflation and strengthen the banking structure. The freedom received from Pakto 1988 apparently spurred excessive and less selective banking credit expansion. To address this problem, the government imposed further monetary tightening or known as Sumarlin's Second Move. For sure, the monetary tightening policies introduced in 1987 and 1991 managed to gradually slow down the inflation rate to 4.9% in 1992. However, the deposit bank rates went up to 27% p.a on average and this triggered expensive cost of fund for domestic banks. As a result, many Indonesian businessmen looked for offshore loans which were relatively cheaper. To cope with the Debt Service Ratio (DSR) burden caused

by such increasing commercial loans, the government set up The Coordinating Team to Manage Offshore Commercial Loans (PKLN) with BI as the coordinator. However, as the presence of PKLN could affect the monetary stability, on 20 November 1991, the government adopted a policy to determine Net Foreign Policy Position, swap facility improvement and loan extension in foreign currencies.

In 1995-1996, Indonesia witnessed heightening investment and consumption activities in Indonesia and this spurred growth to a number of economic sectors (construction and industry). Unfortunately, this surge made the economy to heat up as reflected from the inflation rate that reached 8.9%. To face this problem, Bank Indonesia immediately took a number of steps to control this monetary condition. In the credit extension sector, the government restricted its disbursement and fulfilled SPBU-KUK for banks. While in foreign exchange sector, there was a policy to control the adverse impact of short-term capital flow. Meanwhile, to meet the growing domestic demand and increase non-oil & gas export, the government along with Bank Indonesia took a number of steps through June 1996 Deregulation made up of better efficiency of the production sector, increase of non-oil & gas export and offshore loan security. Finally throughout this deregulation period, the offshore loans in general for the private sector kept rising. As a result, in July 1996, Bank Indonesia issued the Yankee Bond as the benchmark to help acquire offshore loans with softer terms. In this way, the payment burden and risks from such loans could be reduced.

2. Focus Of Policies 1983-1997

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However, such structure could not longer be sustained when the oil price was plummeting in the market from 1980s. To improve this structure, the Government launched some reforms, economic diversification and continued developing the private sector, introduced deregulation, bureaucracy streamlining and even liberalization. Simultaneously, these measures were aimed to prepare Indonesia facing the market globalization process. In this new era, subsidies and protection to the international free trade are prohibited. The monetary policies (including banking) were focused on achieving the said objectives.

3. Strategic Steps 1983-1997

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As a result of this, the mechanism to determine the interest rate and exchange rate was completely left to the market mechanism. BI's Soft Credit was withdrawn in stages, the inter-bank money market was developed through the issuance of marketable instruments, such as SBI and other Money Market Commercial Paper (SBPU), expansion of bank credits were no longer restricted but simply monitored, and Minimum Mandatory Current Account (GWM) which was initially at 30% was lowered to 15% from July 1983, and further reduced to 2% from October 1988. This move aimed to enhance the banks' operational efficiency, and simultaneously give more flexibility to select different types of productive investments.

In this way, the central bank no longer exerted a direct monetary control.

Such deregulation policies were followed with more deregulation moves, among others, changing the exchange rate system from controlled and tight floating to controlled floating but more flexible as from 1986, as well as expanding the banking network since 1988.

As a result of such series of policies, the economic development enjoyed a relatively fast progress and even became overheated due to the influx of offshore loans. Unfortunately, the loans were used to finance consumptive economic sectors, such as the property, shopping centers and automotive. This condition went on until mid 1997 despite the introduction of tight money policy and prudential banking.

4. Foreign Exchange Policies in Indonesia 1983-1997

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To spur the influx of foreign capital, on 25 October 1986, the repeat swap ceiling to BI over its foreign loans was removed.

The falling price of oil and gas in the international market from 1980s put a huge pressure to Indonesia's foreign exchange reserves. As a result of this, the total contribution of oil and gas towards Indonesia's aggregate export dropped from 66.8% to 50.9% in 1986/1987. Worse, the market globalization as characterized by the free competition was putting more pressure to Indonesia's export. Such pressure caused a deficit to the non oil and gas balance of trade. Although the balance of trade as a whole remained a surplus, this was contributed by the foreign exchange influx to the private sector. To maintain its bullish economic activities, the Government borrowed more from overseas. Such foreign loans served as standby loans to maintain its balance of payment outlook.

At the end of this period, as a result of the volatile exchange rates, the public made a huge purchase of foreign currencies. This inevitably put a heavy pressure on how the foreign exchange was managed.

5. Exchange Rate Policies in Indonesia 1983-1997

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In addition to intervention through the foreign currency market, BI also used other instruments to restrict exchange rate fluctuation, for example:

(1) Control of Rupiah Liquidity,
(2) Restriction of Bank Net Foreign Exchange Position, and
(3) Control of Offshore Commercial Loans.

Until the first half of July 1997, the rupiah exchange rate was relatively steady at the level of Rp 2,350 against US dollar..

6. Foreign Debt Policies 1983-1997

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As a result of such strict ceiling imposing and management of foreign borrowings for the State-Owned Enterprises and banks, the private sector attempted numerous ways to execute the projects and seek foreign loans. The projects which had been formerly tackled by State-Owned Enterprises were shifted to private sector projects under Foreign Investment or Domestic Investment schemes. As a result, these projects turned into the largest borrowers overseen by the PKLN team. This growing interest to invest coupled with high economic drive and significant disparity of domestic and overseas interest rates had encouraged the private sector to turn to offshore loans. The Indonesian investors were extremely confident with the country's robust economic outlook. As the private sector had obtained more and more offshore loans, the figure exceeded that of the State-Owned Enterprises and banks. Meanwhile, the borrowings of the Government, State-Owned Enterprises and banks were more controlled.